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## CURRENCIES AND CREDIT MARKETS

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No.198/ October, 1989

Probably the most powerful reason to reduce the rate of interest is the love for one's children and the desire to provide for their well being. Whenever these sentiments decay, as they did at the time of the decline and fall of the Roman Empire, and it becomes fashionable to exhaust wealth in self-indulgence and to leave little or nothing to offspring, impatience for spending and the rate of interest will tend to be high. At such times, the motto "after us the deluge", indicates the feverish desire to squander at present at whatever cost to the future.

The Theory of Interest, Irving Fisher, p. 87  
Porcupine Press Philadelphia, Reprint 1977

### HIGHLIGHTS

The most staggering development in the dollar situation recently is the steep collapse in the interest rate differentials between the dollar and the D-Mark and other Continental European countries.

We think this apparently immense inertia only represents the calm before the storm. Few people realize how threateningly vulnerable currency markets now are and how just how little of a provocation can put the U.S. dollar under massive downward pressure.

Simple calculations that suggests that the U.S. dollar is significantly undervalued in terms of purchasing power against the yen and the D-Mark are insufficient evidence that a strong trade balance is in prospect. All these techniques ignore one of the most vital aspects of currency and trade analysis: capital formation.

In this regard, capital formation and manufacturing investment trends are the most important aspect of the large imbalances between deficit and surplus countries. It is precisely these widely ignored factors that hold the key to understanding the implications of the long-term forces at work.

It is worth emphasizing a key point: In the long run, the strength or weakness of a country's trade balance (and currency) is determined by the state of manufacturing investment.

Britain's current economic malaise is an instructive lesson in what will be awaiting the economies and currencies of other deficit-countries with high-yielding currencies, sooner or later.

What has cracked the pound, is a growing perception that the U.K. economy is heading for the rocks of stagflation. This has always proved to be the harbinger of a currency crisis, the typical ingredients being a vulnerable economy, high interest rates and a weak currency.

Other countries with large external deficits (the United States, Canada and Australia), more or less show the same disease as in the U.K.: disproportionate rise in consumption at the expense of manufacturing investment and foreign trade.

In all of these countries, the new "prosperity" is based on paper assets and profits, the product of speculation and tilting the real economy toward consumption.

## THE EERIE CALM BEFORE THE STORM

All of a sudden, everybody in West Germany agreed that it was high time for the Bundesbank to show a strong hand in countering inflationary pressures, even well before the situation became acute. As our letters have repeatedly stressed, German and European economic growth has been surpassing even the most optimistic expectations. While prices and wages have still been generally well behaved, there clearly was a danger that demand growth may well outstrip potential supply growth.

The main concern for the Bundesbank, though, was booming demand emanating from the rest of Europe. The major question that challenged was how to best curb this foreign demand. The classic response would have been to revalue the D-Mark within the European Monetary System (EMS). However, no government in Europe (including Germany's) is willing to take this step into consideration. For all of them, preserving the existing exchange rate structure retains top priority.

**European Tightening Takes Place in Unison.** On the other hand, conventional wisdom says that it doesn't make sense for a surplus country to tighten its monetary screws. Such an approach would only restrain domestic (and not foreign demand) thus reinforcing the export surplus even further.

However, alongside these present circumstances is the development of a new strand of thinking in the Bundesbank reflecting that institutions growing international role. It is the recognition of this influence that could well have made a virtue of necessity. Given that the option of a currency realignment is not available, there was an alternative to curb demand in Europe as a whole by boosting German interest rates with the implicit aim of imposing a tighter monetary policy on all the rest of EMS partners. In hindsight, that is exactly what has happened in quick succession.

## CONTINENTAL ECONOMIC DRIFT: THE TECTONIC FRONTS BEGIN TO SEPARATE

The world economy is now clearly falling into two different groups: those with continued strong economic growth (Continental Europe and Japan along with the newly industrialized countries in the Far East) and another group where signs of slower growth prevail (United States, Britain, Canada and a few others). In general, it is the deficit countries economies that are weakening.

This de-synchronization of the world economy is beneficial for two reasons: first, it cools commodity prices; and second, it should help moderate - at least for the time being - the threat of a "hard landing" for aggregate world growth. This would occur through two channels: first, by the stimulus of the sharply rising import demand of the booming countries; and second, by the vast amount of money, credit or capital that the surplus countries are pumping into the deficit countries.

**Deficits: A Sign of Success or Policy Failure?** Where are the limits? As the currencies of the deficit countries remain unyieldingly strong and while the currencies of the surplus countries remain just as stubbornly weak, many people have come to the conclusion that this must be a new era in which current account imbalances of whatever size don't matter any more. Globalized financial markets are ever eager to finance and accommodate ever-growing deficits.

To quote Nigel Lawson, British Chancellor of the Exchequer, from his recent speech at the IMF meeting in Washington: *"The international capital markets are carrying out one of their fundamental roles - allocating excess private sector savings to the countries with investment opportunities that exceed their domestic savings. For any country, this means that investment is not constrained by its own savings."*

After his song of praise on large deficits in general and the British one in particular, Mr. Lawson advanced another new theory, one presumably based on historic experience: In a world of capital mobility and little government intervention, large imbalances should really be regarded as natural and normal. As proof, he referred to "*new studies*" which show that similarly large imbalances as today were rampant "*in the era of the classical pre-1914 gold standard*", the last extended period when capital could move freely between countries.

The intended message of these comments, as might be guessed, is that today's large deficits have nothing to do with bad governmental policies. Rather, large external deficits are the natural outcome of strong capital inflows from those countries where savings are in excess of domestic investment opportunities in comparison to those countries where opportunities fall short of savings. In other words, we are asked to believe that deficits are the bi-product of success.

#### **BRITAIN: LIKE FATHER, LIKE SON**

We think that both Mr. Lawson's comment and Britain's present economic and currency troubles are symptomatic. The comment of Mr. Lawson is, of course, symbolic of the general complacency over large external deficits. Britain's current economic malaise, on the other hand, is a lesson on what will be awaiting the economies and currencies of other deficit-countries with high-yielding currencies, sooner or later.

**From Paladin to Pariah, Overnight.** All of this is taking place just a short seven to eight months after the pound was forging past DM 3.20. The British pound was making a run against the DM which appeared unstoppable in February. To quote a well known chartist at the time: "*The now consolidated break through the DM 3.25 neckline, opens the prospect of a move right across our rising parallels to a target of DM 3.38, unless this relatively mature bull runs out of steam before it gets there.*"

At the time, the British base rate was at 13.5%. In the "soft landing" scenario that was widely expected to follow, the impact of weak domestic demand growth was supposed to be partially offset by lower imports and higher exports. That was confidently seen to be the sure-fire tourniquet for a progressive staunching of the massively haemorrhaging current-account deficit.

As such, GNP growth would be supported as the balance of payments strengthened. With that economic backdrop, it was reasoned that the government would be able to respond to subdued domestic activity by allowing interest rates to decline. The only possible risk in all of this was a controlled devaluation of the pound at worst.

**What Went Wrong?** Just about everything. Inflation, the trade balance and interest rates ran off into unanticipated directions. While the economy meanwhile weakened even more than had been expected, the government had to raise its base rate to 15% as gloom over inflation and currency weakness compelled it to reassure the jittery exchange markets.

In the meantime, consumer spending has slowed down considerably as had been desired by policy makers and markets. However, the expected positive effects on inflation and the trade balance are still completely out of view as of yet. In fact, to the contrary, both measures have drastically deteriorated. That has uncomfortable implications since it means nothing less than total policy failure.

**The Anatomy of the Reappraisal of the Pound.** Reassessment of economic policies and trends led to a reassessment of the currency. In the first instance, a soft landing of the economy requires that the consequent gap in domestic demand be filled by rising net exports - either export growth and import replacement. However, the worsening U.K. trade balance shows that a compensating offset has failed to materialize.

What has cracked the pound is a growing perception that the U.K. economy is heading for the rocks of stagflation. This has always proved to be the harbinger of a currency crisis - the typical ingredients being a vulnerable economy, high interest rates and a weak currency. Fearful that a sliding currency might unduly worsen inflation, interest rates have had to be kept at high, recession-threatening levels.

With this backdrop, in the final analysis it is the emerging fear of an unfolding recession - and not the worsening trade, nor the rising inflation rate - that have suddenly triggered the heavy downward pressure on the pound.

What makes the pound vulnerable in this case is that a weakening economy leaves the authorities little scope to defend the currency with still higher interest rates, should such a measure be needed. Under these conditions the fear of a weak currency becomes self-fulfilling.

**The Example of Britain Applies to Other Countries.** Earlier we said that the current predicament of Britain's economy and currency is instructive for what is awaiting other countries with large deficits and high interest rates. Why? Because, apart from a number of differences, all these countries have the same root problems: overconsumption, undersaving and underinvestment caused by reckless credit expansion.

#### **THE COMMON EVIL: INADEQUATE CAPITAL FORMATION**

According to the consensus view, all these deficits are due to nothing more than a temporary overstimulation of domestic demand. Seen from this perspective, all that is required to fix the machinery is to again reduce demand through moderately tight money.

Proponents of this view are sadly mistaken. What these observers fail to realize is the fact that six, seven or more years of overconsumption and underinvestment has taken a heavy toll on the growth potential of these economies. The whole question of currency movements now takes on much deeper questions. Yet, the whole currency discussion today centres on only money supply, purchasing power and relative demand conditions. It follows then that it is from these three factors that the dollar bulls draw their main arguments. But what they completely ignore, is that in the long run, a country's trade performance depends on more than just demand control and a favourable cost position.

**The Most Overlooked Aspect of Currency Analysis.** A fourth but most indispensable requisite in any currency question lies squarely on the supply side of the respective economy. Sufficient capacity growth is required to accommodate both higher exports and domestic demand. Adequate capacity growth, in turn, depends on sufficient investment, particularly manufacturing investment, since the bulk of tradable goods comes from the manufacturing sector.

In this regard, capital formation and manufacturing investment are certainly the least examined aspects of the large imbalances between deficit and surplus countries. Yet it is precisely these factors that hold the key to understanding the implications of the long-term forces that are at work.

From that perspective it is worth reemphasizing a key point: In the long run, the strength or weakness of a country's trade balance is determined by the state of manufacturing investment.

**It All Starts With Overconsumption.** In the final analysis, the malaise of the British pound originates in persistent overconsumption, undersaving and underinvestment as compared to its major foreign competitors. Quoting the Financial Times: "*There is simply not enough manufacturing to go around.*" What few people realize is that this

"British disease" has worsened in the 1980s despite the generally positive perception of "Thatcherism".

Here again we come to the point of this British illustration. It is that other countries with large external deficits (the United States, Canada and Australia) show, more or less, exactly the same disease: a disproportionate rise in consumption at the expense of manufacturing investment and foreign trade. In all of these countries and some others, the new "prosperity" is based on paper assets and profits: the product of speculative markets and tilting the real economy toward consumption.

**Britain's Record Has Been Dismal.** Here are a few facts about the British economy in the 1980s which the defenders of "Thatcherism" have unduly ignored. Present industrial output is barely higher than in 1979 and is still below that of 1973. Yes, it is true, fixed investment rose, but it nevertheless fell as a proportion of GNP. Fixed investment in the category of plant and machinery rose at the highest rate. However, this "investment boom" was centred on consumer related distribution, financial and business services, while fixed investment in manufacturing industry actually declined.

#### THE HEALTH AND WEALTH OF THE U.S DEMAND SIDE

The consensus view has always been (and still is) that the U.S. boom of the 1980s was very healthy by historical comparison because it was associated with falling inflation and rapidly rising employment. It is our impression that this positive perception remains the dominant influence on markets, being clearly manifest in the strong U.S. dollar and bond and stock markets.

From the viewpoint of many observers, the U.S. economy has staged a "miraculous" supply-side recovery. The central promise of Reagan's program was that drastic tax-cuts would launch a savings and investment boom, leading to sharply higher productivity growth - that being the key to rising real income for everyone. The ultimate irony - though apparently not yet realized by most people - is that virtually none of these objectives have yet been fulfilled.

Exactly the opposite has occurred as far as capital formation is concerned. In the interim, both savings and the investment ratios have fallen to post-war lows. Aside from the temporary effects of the business cycle, productivity growth in the overall economy hasn't improved at all.

**The Demand-Side Benefits at the Expense of the Supply-Side.** In the United States, just as in Britain, the recovery in the 1980s has been powered by the adrenaline of debt. In both countries, resulting debt levels easily match the debt excesses of the 1970s. The great and crucial difference between the two periods, however, lies in the application of new debt. In the 1970s, debt was mainly employed to finance investment, particularly building and inventories. This time, in contrast, the spewing stream of money from rampant credit inflation has been much more widely dispersed than in the past.

The only common targets of credit excesses in these two periods have been commercial building and housing. This time, the greater part of the credit inflation has affected financial markets, most spectacularly the stock markets (takeover fever), bond markets, imports and consumer borrowing.

Consumption soared as the American and British consumer felt enriched because household wealth surged. That happened two ways: firstly, by the spectacular uptrends in the stock and bond markets; and secondly, through extraordinary gains in house prices.

**Over-Consumption Breeds Contentment.** For many, if not most people, the economic recovery experienced in the United States appeared to have been the most vigorous of all in the after-war period. The hallmarks of success, in this view, were its unusual length, strong employment growth, moderate inflation (if 5-6% inflation can indeed be considered moderate) and last, but not least, the extended bull market in bonds and stocks. What better set of conditions could one have wished for?

The basic but crucial fallacy in this rosy picture is that it completely ignores the fact that this expansion period has ravaged America's capital structure and has left in its wake a staggering capital scarcity. Consumption has been boosted to high levels at the dire expense of investment and export.

**The Dimensions of the U.S. Overconsumption Problem.** During the 1970s, altogether 92.1% of U.S. national product was absorbed by consumption - the private share accounting for 69.3% and government spending 22.8%. The portion attributable to investment only amounted to a paltry 7.6%.

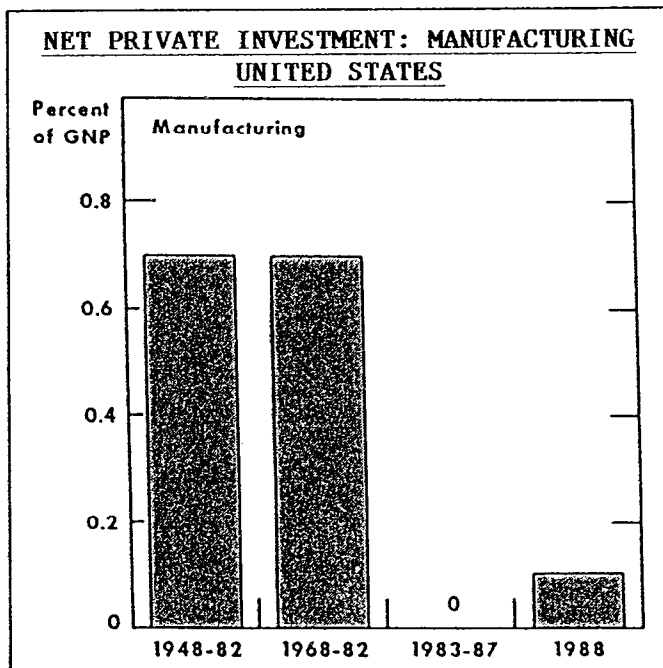
After Reaganomics - the widely trumpeted antidote for low savings and investment - developments continued to deteriorate. Post-1980, private consumption jumped from 69.3% to 74% of national income - up nearly five percentage points. Together with government spending, consumption now absorbed 98% of national income, against the 92.1% during the 1970s. Net investment, on the other hand, was cut by one third to an emaciated share of only 4.7%.

**Manufacturing Investment Takes the Fall.** Worst of all, the entire decline in investment came from the business sector, and most detrimentally from manufacturing investment. Unbelievably, even though the U.S. economy has boomed for seven full years, net manufacturing investment remained absolutely flat through to 1987 and edged up only slightly in 1988. That standstill in manufacturing investment easily qualifies as the most pronounced shortfall in capital accumulation of the entire post-war period.

#### THE RELATIONSHIP BETWEEN OVER-CONSUMPTION AND LAGGING MANUFACTURING INVESTMENT

Against that shabby reality, one must now consider the consensus view that the U.S. economy has proven victoriously resilient against the onslaught of tight money and a strong dollar. However, as we've shown, the presumed resilience is only partly true. While a masquerade of GNP growth and robust employment gains seem to support this view, in reality a grossly disproportionate development of consumption and investment lies hidden from view.

Manufacturing investment has been squeezed out, a development which has serious long-term consequences. The chart showing manufacturing net investment trends as a percentage of GNP leaves our assertions in little doubt.



#### The Consumer is the Short-term Victor.

Ballooning consumption and languishing manufacturing investment are not accidental bed-mates. One must remember that it is relative prices that determine the amount

and direction of production. In America's case, rising interest rates and exchange rates (the latter caused by huge capital inflows) have impacted various parts of the economy in different ways.

Hardest hit are the manufacturing sector's profits and investments. That happens for two reasons: first, it is the only sector that is exposed to foreign competition; and second, because production capability tends to be highly capital-intensive. By contrast, a strong currency does not squeeze the consumer except over the long run lest he become unemployed. Rather, a strong currency even favours the consumer. The consumer's purchasing power is increased (at the expense of business profits) and to the extent that capital inflows drive up asset prices (bonds and stocks). In sum, a strong currency serves to even increase wealth.

#### **CAPITAL SCARCITY CAUSES SERIOUS ECONOMIC MUTATIONS**

Over time, overstimulated consumer demand, fuelled by easy credit and burgeoning paper profits, inexorably changes the overall pattern of demand, output, investment and employment. As we see in the United States, the counterpart to a relatively shrinking industrial base is a booming service sector. This sector - being neither sensitive to high interest or exchange rates - becomes the major source of GNP and employment growth.

It might be said in another way that the whole economy adapts to a new production structure that requires little capital. What's wrong with that as long as employment keeps rising? Well, capital formation is the key to many important factors: it's the well-spring of productivity development, capacity growth in the manufacturing sector, high-paying jobs, higher living standards, international competitiveness, strong trade balance, a solid currency and true prosperity (in contrast to inflationary paper prosperity).

Of all these munificent fruits brought about by capital formation, the one that is least examined and understood is capacity growth. Yet in the case of Britain and the U.S., manufacturing's capacity to expand or maintain market shares at home or abroad is rarely a topic of analysis. As simple as this point may be, the essence is absolutely vital.

Simple calculations that suggests that the U.S. dollar is significantly undervalued in terms of purchasing power against the yen and the D-Mark are in themselves insufficient evidence that a strong trade balance is in prospect. After all, an implicit assumption in that calculation is that manufacturing investment will be free to expand to the level necessary to exploit a given price competitiveness.

#### **THE LONG-TERM OUTLOOK FOR THE U.S. DOLLAR**

Given our foregoing analysis we can now pursue three questions important to determining the outlook for the U.S. dollar. How strong is the U.S. economy actually? How will the U.S. trade balance perform over the long run? And, what are the probable consequences for the U.S. dollar?

On the first question we can only say don't be deceived by "higher-than-expected" GNP and employment growth. As we have pointed out, continuous strong growth in lower-paid service jobs has masked an eroding industrial base.

On "manufacturing matters" and the trade balance to this point, it is our opinion that the improvements that have occurred in the last two years were for the most part the result of a drastic reversal in international demand conditions - weakening U.S. domestic demand versus soaring demand abroad. Under more normalized demand conditions, U.S. trade improvement would have been tortuously slower, if at all.

We argue that U.S. trade improvement over the longer-term will be disappointing. That conclusion stems from our analysis of the deep-seated structural changes in the U.S. economy caused by capital scarcity and insufficient manufacturing investment. The low level of industrial investment virtually guarantees that the U.S. trade balance will continue to deteriorate over the long run.

**Recent Dollar Performance.** In our view, the buoyancy of the U.S. dollar in the past months was mainly the figment of market psychology and had very little to do with objective facts, one of which was the improving trade balance. Confidence in the Federal Reserve's splendid economic management and its ability to engineer the famous "soft landing" probably had the greater influence.

We distinctly disagree with the highly positive assessments of both the Fed's policy and the U.S. economy's mythical resilience and dynamism. We do not share the view that the Fed has been very cautious. Exactly the contrary is true. There was little doubt that U.S. domestic demand had to be curbed for obvious internal as well as external reasons. Hence, the Fed raised interest rates, a move which was applauded by all. However, at the first whiff of an economic softening, panic set in.

While Mr. Greenspan continued to speak forcefully, he acted softly, easing immediately. Considering that price inflation remains around 5% levels and real GNP growth at 2.5%, it can only be the product of wild imagination that an interest rate reduction of around one percentage point could possibly be termed as cautious.

Although we think that the Fed acted precipitously rather than cautiously, we have great sympathy for the probable motive. While markets may be blind to the enormous perils inherent in the reckless leveraging of corporate and financial America, Mr. Greenspan and others in the Fed are not. In this high-leverage environment, their fear is that a recession may well mean financial doomsday. The reaction of the Fed clearly betrays the desire to prevent recession at any price. If necessary, they will open the flood gates of the money supply and force short-term rates lower.

#### THE BULWARK FOR THE DOLLAR IS DISMANTLED

As U.S. rates fall it is worth reviewing that the recent dollar rally of 1988-89 was mainly caused by (1) relatively tighter money in the United States than in Japan and Germany, (2) large and rising interest rate differentials, (3) an improving trade balance and (4) general confidence in U.S. economic policy and the strength of the economy. As much as the dollar rally was still contrary to long-term fundamental factors, at least there was some real gusts that might have caught the sails.

The most staggering point in the dollar situation that surprises us more than anything else recently is the steep collapse in the interest rate differential between the dollar and the D-Mark and other Continental European countries. Theoretically, the sails of the dollar rally should now be drooping. Amazingly, the virtual disappearance of the rate differential has so far only had a muted impact. Should that be cause for relief or is it one last chance to head for the hills before the tidal wave hits?

**The Still Before the Squall.** We think it is only the calm before a new chilling gust will blow from the cold North. In the meanwhile, markets are buzzing with phoney theories (relative monetary growth, purchasing power, etc.) that all seem to rationalize and justify long-term dollar strength. One hardly hears any mention of the fact that the interest rate advantage of the U.S. dollar against the D-Mark has virtually collapsed. U.S. short-term interest rates have fallen to 7.6% while German rates have risen sharply to 8.25%. In the Euro-deposit markets the differential on three-month deposits has shrunk to barely 30-40 basis points compared to the 400 points favouring the U.S. dollar back in March!

What, then, is still supporting the U.S. dollar given the virtual disappearance of its interest rate advantage against the D-Mark? It can only be pumped-up psychology and the resultant "hot money" speculation prompted by the promised long-term bull market of all these contrived theories.

**Present Psychology Sets Up A Vulnerable Situation.** As such, given the general dollar bullishness that has been heavily promoted over the past years, most corporations and investors have become rather complacent over their "long" dollar positions and are not likely to be "short". Since, in their view, the prospects of dollar appreciation outweigh the risk of depreciation, there is a general tendency to abstain from covering dollar exchange risk for the sake of securing the full benefit of the interest rate differential together as well as the potential for profiting on any exchange move.

Few people seem to realize how threateningly vulnerable the whole situation currently is and just how little of a provocation can put the dollar under massive downward pressure. All that is required is for investors to smell the stench of significant downside risk. Even if such realizations do not create an immediate "bear attack" against the dollar, it would at least increase the inclination to cover the exchange risk. Of course, such covering operations will have exactly the same effect on the dollar's exchange rate as any speculative attack.

**The Accelerating Effect of Hedging Transactions.** There is another reason why we want to draw attention to the mechanics of covering exchange risk. It concerns the impact of such hedging or speculative operations against the dollar and its exchange rate. How these covering transactions work is familiar to traders, of course. But, for most individual investors and economists, these trading mechanisms and techniques seem about as complicated as neuro-surgery. However, an understanding of these trading techniques is of crucial importance, particularly if one wishes to understand the lightening impact they can have on dollar moves.

Covering an exchange risk in this case means that corporations and investors sell their dollars forward against D-Mark. The counterparts in these transactions are usually banks who then assume the exchange risk. These banks then have to cover themselves too. And they do that through another transaction. In that step they usually match their forward dollar purchases "spot" by borrowing dollars (in the Euro-market) and switching them into the currency sold forward. This way, any sales pressure on forward dollars translates immediately into a corresponding pressure on the spot dollar.

As a result of these activities Euro-banks experience a sharp increase in the demand for dollar credits, for which, by the way, U.S. banks stand as the "lender of last resort". In the final analysis, it produces an increase in dollar credits to the rest of the world for which the U.S. financial system tends to act as the residual supplier of dollars. Essentially, it's a mechanism that leads to capital outflows from the United States depressing the dollar in the spot market. One might say, the Euro market shifts the downward pressure from the forward market to the spot market.

**A Vicious Circle Kicks In.** We've taken labours to explain these mechanisms in some detail to show how vulnerable the dollar can be to any loss of confidence. Even if there isn't any outright speculation against the dollar, hedging operations will have the same effect. To us, it only seems a matter of time before waning dollar bullishness will trigger concerted hedging against any fall of the dollar (especially in view of the extremely low costs). That in turn will produce pressure on "spot" and in turn trigger even more hedging. It's a situation that could easily fall into the rut of a vicious circle.

## **A PRACTICAL WAY FOR AN INVESTOR TO LIMIT DOLLAR RISK**

Any investment in a foreign currency involves an exchange risk which under a system of today's flexible exchange rates is in principle far higher than any possible interest rate advantage. Yet, it is quite common that individual investors generally abstain from covering potential exchange risk.

Here is an example of a hedging transaction designed to limit dollar risk. We'll demonstrate using the situation of a West German investor. This investor can eliminate the exchange risk on his U.S. dollar bonds in two ways: first, by forward sales of dollars against forward D-Mark; or, second, by borrowing dollars and selling them spot against D-Mark.

What are the costs of these alternate transactions? It all depends on the interest rate differential between the two currencies. If the differential is high, the costs can become rather prohibitive. But in the case of the U.S. dollar and the DM the costs are extremely low at the moment. Interest rate differentials between the U.S. dollar and the D-Mark are at an unusual low of barely 0.5% (or less) as already mentioned. In other words, that's virtually all it would cost a German investor to safeguard against any dollar depreciation. That's cheap insurance by any standard.

However, in the case of the Canadian or Australian dollar, covering against the exchange risk would be rather expensive due to the large interest rate differentials. Therefore, we would advise German investors to hedge against the U.S. dollar as a proxy for these currencies, given their direct linkage to the U.S. dollar.

## **THE HARROWING QUESTION OF DOLLAR-TIMING**

To be frank, it is conceivable that it could take a little while before a "dollar crisis" gains serious momentum. For now, Federal Reserve Chairman Greenspan still retains the confidence of international financial markets and hopes of a "soft landing" for the U.S. economy remain high. Therefore, sentiment towards the dollar still retains a positive bias. Despite our evidence to the contrary, alone the fact that the dollar has been strong for one and a half years causes many observers to assume that the U.S. dollar must be solidly based.

Perversely, the orchestrated dollar interventions of central banks designed to weaken the dollar in recent weeks may well have encouraged the dollar bulls. But be assured, that's a bullish heroism literally living on borrowed time. The truly critical phase for both the U.S. dollar and stock market will begin when the U.S. economy shows itself to be weaker than expected. Then, as markets begin to anticipate a recession, significantly easier money and lower interest rates, blind confidence will turn into doubting disappointment.

Contrarily, many people think that a U.S. recession will strengthen the dollar rather than weaken it. The reasoning here is that, firstly, a recession will reduce import demand and thus improve the trade balance; and second, because the prospect of large capital gains on U.S. bonds resulting from sharply falling interest rates should boost the dollar by drawing in even more capital imports.

We disagree. In our view there is little doubt that the dollar will take a dive when the U.S. economy goes into recession. U.S. stocks and bonds will follow suit. In the case of bonds, we do have some reservations on Treasury bonds, however. A "flight to quality" may overwhelm the negative influences of a weak dollar and foreign-investor liquidations. However, in this instance, it is a forgone conclusion that low grade bonds will be hit even harder.

As we see the latest U.S. economic trends, there is plenty of evidence to support that view. And our short look again establishes that the real underlying trends are completely obfuscated by the short-sighted obsession with monthly statistics.

#### U.S. ECONOMIC TRENDS: FUNDAMENTALLY WEAKER

In the past, U.S. recessions have been "V"-shaped. A sharp economic downturn was usually followed by a vigorous recovery. Past downturns were mainly induced by sharp inventory cycles and temporary credit crunches. The American consumer usually escaped any serious impact.

This time, we think the recession promises to be very different. While inventory excesses may not be as protracted, there have been many other kind of excesses. The most notable of these is a huge behemoth of deflationary debt which lumbers consumers and corporations and exposes the financial system to a heightened vulnerability as never before.

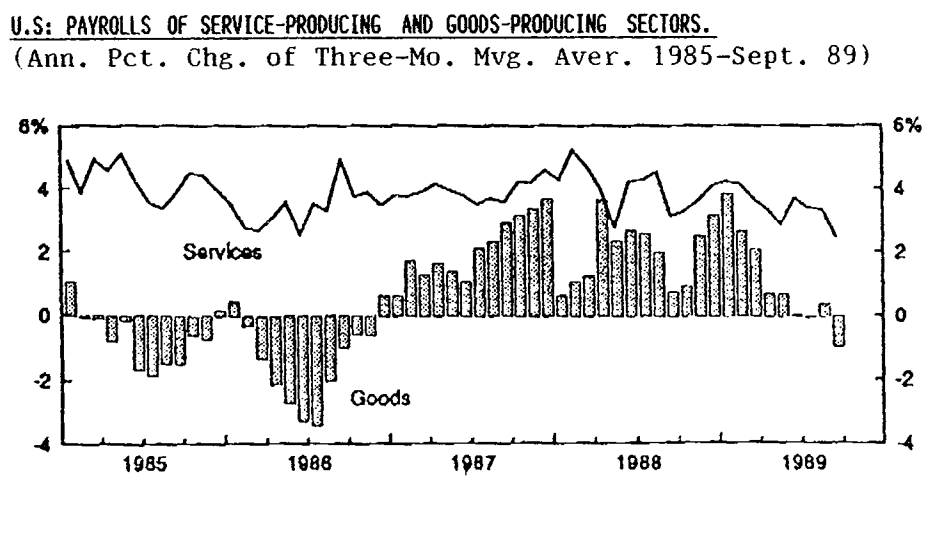
**Focus is on the Industrial Sectors.** At the moment, many observers maintain that the U.S. economy is immune to a recession. The key cornerstone to that view is the notion that any weakness in the manufacturing sector - accounting for no more than 22% of GNP and 18% of total employment - will be offset by continuous strong job and income gains in the service sector. This has been the pattern for so long that many economist now take this continuation for granted and count it as a virtue.

But in reality, apart from the fact that these expectations are fundamentally flawed over the long-term, recent data already challenges that view. There has been a dramatic decline in U.S. job and income growth during the past months. Here are two quotations from the "U.S. Financial Data" of the Federal Reserve St. Louis:

*"Personal income rose at a 5.4% annual rate in August, about the same as its growth rate since April, but much slower than its 10.9% rate during the eight months ending in April." (That's, of course, nominal income).*

*"Civilian employment fell at a 0.3% annual rate over the past three months, following a 1.4% rate of increase from March to June, and a 3.1% rate of growth over the six months ending last March."*

It's clear that a sluggish industrial sector is calling the economy's tune. Manufacturing production is still up against a year ago by 2.5%. But new factory orders are singing the blues as the key sources of factory demand have slackened throughout the course of this year. Consumer spending and business outlays for equipment and exports have been slowing simultaneously. Yes, even exports too.



**Many Signs of a Weakening Economy.** Despite the booming world economy, U.S. exports have been flat since March at levels slightly over \$30 billion per month. All the while, imports continue to rise gradually. The outlook for business capital spending, given the squeeze on business profits, must be considered bleak. Excluding the temporary boom in aircraft orders, capital goods orders are down sharply (and that includes export orders).

It is our opinion that these and many other factors together point to an economy that is considerably softer than many of the summertime readings imply. In our view, growing disappointment about the underlying strength of the U.S. economy and business profits will hit both the dollar and the stock market hard... and sooner than later. Just as the two markets have risen together, they will also fall together.

To this point, the economic slowdown is regarded as a welcome pause before the U.S. economy takes off again. However, this over-confidence will give way to panic as soon as the alarm bells start ringing in a U.S. recession.

### SUMMARY CONCLUSIONS

America's trade balance is bound to deteriorate. The reason is simply this: insufficient capital formation. In a growing world economy, market shares cannot be sustained unless manufacturing capacity expands in step with those of major competing countries.

In this respect, the U.S. and Britain are losing ground and it seems at an accelerating pace. During the 1980s, the United States experienced its most anaemic capital formation performance on record. In contrast, major competing countries have boosted their capital spending.

Even if American industry is competitive in terms of price and cost, it's growing shortfall in capital accumulation implies bleak prospects for the U.S. trade balance. This capital formation deficiency is certain to have implications for the exchange rate.

One thing is absolutely certain: time is against the dollar. The factors that fuelled its bull market - a strong economy and rising interest rates - are all now matters of the past. In fact, relative monetary and economic conditions are shifting to a mix that has become increasingly depressing and negative for the dollar.

Confidence in a currency decreases as the respective economy declines. In the past, any sharp slowdown in the U.S. economy, relative to the German and European economies, always triggered a dollar crisis even despite the lure of attractive U.S. interest rates.

This time, the cyclical mismatch is more pronounced. The interest rate differential is smaller than ever. And that's only for beginners. As a recession hits the over-leveraged colossus of debt there is every potential to believe that prospects for the dollar will deteriorate further.

And when the mechanisms of dollar covering and hedging transactions begin to swing into action the situation could become quite a spectacle. When we say that the U.S. dollar could take a steep dive sooner or later, quite frankly, we mean it literally.

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Publisher/Editor: Dr. Kurt Richebächer  
Muehlegasse 33, CH-8001 Zuerich, Switzerland

Annual Subscription:  
SFr. 600.-/US-Dollar 400.- for subscribers outside Europe.

Languages: German/English

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